

— STATEMENT OF DETERMINATION AND ORDER —
OF THE
SECRETARY OF FOOD AND AGRICULTURE

*REGARDING PROPOSED AMENDMENTS
TO THE STABILIZATION AND MARKETING PLANS FOR MARKET MILK
THAT ADDRESS THE CLASS 4b PRICING FORMULA*

BASED UPON A PUBLIC HEARING HELD ON MARCH 28, 2001

*Signed in the Office of the Secretary
Monday, May 21, 2001*

SUMMARY OF DETERMINATIONS

A duly noticed public hearing was held by the Department of Food and Agriculture (Department) on March 28, 2001 to consider adjustments to the Class 4b pricing formula. At that hearing, testimony and evidence were introduced into the record regarding the proposal to include a whey factor in the Class 4b formula. Additional testimony was submitted in the form of briefs during a one-week period following the close of the hearing. Summary of witnesses, testimony and evidence can be found in the Panel Report to the Secretary of Food and Agriculture.

In weighing the testimony and evidence on the hearing record, the Department has determined that the current Stabilization and Marketing Plans for Market Milk continue to effectuate the declared purposes of the Food and Agricultural Code.

This document contains the analyses that were used to develop the Determination as issued by the Department. As with any analysis using historical data, the Department issues a caveat that the past is not necessarily a good predictor of the future.

TABLE OF CONTENTS

• Introduction and Summary of Proposal	Page 4
• Background	Page 5
• Add a Skim Whey Powder Factor to Class 4b Pricing Formula	Page 7
• Findings of the Department of Food and Agriculture	Page 13

INTRODUCTION

The Department held a public hearing on March 28, 2001 in Sacramento, to consider amendments to the Class 4b pricing formulas as provided in the Milk Stabilization and Marketing Plans for Market Milk (Plans). The Department called the hearing after receiving separate petitions submitted by the Alliance of Western Milk Producers (Alliance) and by Milk Producers Council (MPC). Before the hearing, major changes were made to the petition and the alternative proposal submitted by the Alliance and MPC, respectively. The Alliance withdrew its petition and developed an alternative proposal to MPC's petition. MPC withdrew its proposal in favor of the alternative proposal developed by the Alliance. The hearing was limited to amendments to the Class 4b pricing formula.

California Food and Agricultural Code Section 61801, *et seq.*, provides the authority, procedures and standards for establishing minimum farm prices by the California Department of Food and Agriculture (Department) for the various classes of milk that handlers must pay for milk purchased from producers. These statutes provide for the formulation and adoption of the Plans.

Summary of Proposal:

The proposal would add to the current Class 4b formula a factor reflecting the value of skim whey powder. The current Class 4b formula equals the sum of:

$$\textit{Cheddar cheese factor} + \textit{whey butter factor}$$

The proposed Class 4b formula would equal the sum of:

$$\textit{Cheddar cheese factor} + \textit{whey butter factor} + \textit{skim whey powder factor}$$

BACKGROUND

The following economic data and statistics were considered when examining and evaluating the proposals and testimony submitted at the hearing.

California Milk Production

California continues to produce more milk from more cows:

- Annual milk production has increased every year since 1978.
- Milk production has increased at an average rate of 4% for the last ten years; nationwide, the figure is slightly less than 1%.
- In 1999, milk production increased at double-digit levels because of high milk prices and low feed prices during 1998 and 1999.
- In 2000, annual milk production reached 32.2 billion pounds.
- Cow numbers have **increased** by an annual average rate of 2.6% for the last ten years; nationwide cow numbers have **decreased** at a rate of 1.4%.
- In 2000, cow numbers increased by an average of 5,000 per month.

California Cheese Production

The cheese industry is a major part of the growing California Dairy industry:

- In 2000, 39% of California's total milk production was used to make cheese.
- California is ranked second in the U.S. for cheese production, with an 18% share of the market.
- California cheese production has doubled over the last ten years to 1.4 billion pounds.
- Cheese production in California has grown by an average of 8% per year over the last ten years. Over the last ten years, the rest of the U.S. only averaged 2.7%.
- During 2000, cheese production increased by 10% over 1999 totals.

Minimum Price Levels

- With the exception of the outstanding pool paid to producers in 1996, 1998 and 1999, the pool prices from 2000 were on par with previous years (see Table 1).
- California's Class 4b prices have dropped significantly since 1998. The low annual average minimum class price in 2000 was a reflection of a surplus production of cheese.
- The cheese market is showing signs of increasing strength. Since January 2001, the Class 4b price has increased by \$2.12 per hundredweight.

Table 1. California Pool Prices; Annual Averages, 1990 to 2000

	<u>Quota</u>	<u>Overbase</u>		<u>Quota</u>	<u>Overbase</u>
1990	\$13.03	\$11.00	1996	\$14.57	\$12.87
1991	\$12.03	\$10.23	1997	\$13.54	\$11.84
1992	\$12.26	\$10.87	1998	\$15.84	\$14.14
1993	\$12.07	\$10.72	1999	\$14.40	\$12.70
1994	\$12.48	\$10.78	2000	\$12.46	\$10.76
1995	\$12.66	\$10.96	<i>Average</i>	\$13.22	\$11.52

Price Alignment with Federal Milk Marketing Orders

- California's Class 4b prices may vary month to month, just as the federal Class III prices vary. However, over the longer term, both pricing systems result in similar price levels (Figure 1 and Table 2).

Table 2. Comparison of California and Federal Order Cheese Milk Prices using Current Formulae, October 1998 to December 2000

	<u>Class 4b</u>	<u>Class III</u>
Maximum	\$16.91	\$17.51
Minimum	\$8.71	\$8.58
Average	\$11.55	\$11.76

**Alliance of Western Milk Producers:
Add a skim whey factor to the Class 4b pricing formula**

Background

Prior to the hearing, the Alliance of Western Milk Producers (Alliance) requested a postponement of the hearing schedule for protein pricing. The Department acted on the request and limited the hearing to the issue raised in the Milk Producers Council (MPC) petition, i.e., whether or not to include a whey factor in the Class 4b pricing formula. The Alliance then developed an alternative proposal to MPC's concept of including a whey factor in the Class 4b pricing formula. The Alliance's approach differed from MPC's by using a lower yield and a fixed manufacturing cost allowance. MPC withdrew its own proposal in favor of the alternative proposal developed by the Alliance. Because MPC withdrew its original proposal in support of the Alliance proposal, and there was no testimony in support of MPC's original proposal, it was not analyzed or considered by the Department. The Alliance proposal was supported by MPC and Western United Dairymen, and they presented the proposal as a unified position among all three organizations.

Introduction of Proposal

The Alliance proposed that a whey component price be introduced into the Class 4b formula. The proposed addition to the pricing formula would impact the solids-not-fat (SNF) component price but would leave the fat price unchanged.

The supporters stated that whey processing in the cheese industry has matured to a point where its positive economic value should be included in the Class 4b pricing formula explicitly. The proposal uses a simple formula similar to that used to price nonfat dry milk, i.e., a monthly average of whey prices, a manufacturing cost allowance and a yield factor. The monthly whey price is the average of the weekly whey prices reported in Dairy Market News, and the manufacturing cost allowance is set at \$0.14 per pound. The supporters have proposed a yield factor of 5.75, i.e., a processor can produce 5.75 pounds of dry whey from 100 pounds of milk. The proposal also includes a provision to limit the economic impact to the formula such that the revenue contribution from the whey factor to the SNF component price cannot be less than zero.

Impact of Proposal

Table 3 shows that the potential impact of the proposal on minimum class prices and on pool prices. If the proposal were in effect from October 1998 to February 2001, the proposal would increase the Class 4b price by an average of \$0.31 per hundredweight per month, with a maximum of \$0.85 and a minimum of \$0.02 per hundredweight per month. When compared to federal milk marketing order prices over the same time period, the average class price difference is \$0.04 per hundredweight per month. Pool prices would be increased somewhat by the proposed amendment to the Class 4b pricing formula. A slightly larger impact is shown for the more recent time period, a result of the continuing trend of increased use of California milk production in Class 4b. Accordingly, the proposal would have increased pool prices by an average of \$0.11 per hundredweight per month for the ten-year period ending in 2000. A more recent time period (October 1998 to February 2001) reveals that pool prices would have increased by an average of about \$0.12 per hundredweight per month.

Table 3. Impact of Proposal on Class and Pool Prices		
Class 4b	Current Formula	Proposed Formula
1990 – 2000, average	\$11.44	\$11.75
Oct. 1998 – Feb., 2001; average	\$11.52	\$11.83
Oct. 1998 – Feb., 2001; minimum	\$8.71	\$8.98
Oct. 1998 – Feb., 2001; maximum	\$17.14	\$17.71
Class 4b Increase		
1990 – 2000, average	—	\$0.31
Oct. 1998 – Feb., 2001; average	—	\$0.31
Oct. 1998 – Feb., 2001; minimum	—	\$0.02
Oct. 1998 – Feb., 2001; maximum	—	\$0.85
Class 4b less Federal Class III		
Oct. 1998 – Feb., 2001; average	–\$0.27	\$0.04
Oct. 1998 – Feb., 2001; minimum	–\$1.75	–\$1.26
Oct. 1998 – Feb., 2001; maximum	\$1.04	\$1.24
Change in Pool Prices		
1990 – 2000, average	—	\$0.11
Oct. 1998 – Feb., 2001; average	—	\$0.12

Oct. 1998 – Feb., 2001; minimum	—	\$0.01
Oct. 1998 – Feb., 2001; maximum	—	\$0.34

A closer inspection of monthly prices indicates that the proposal does little to alter month to month price fluctuations when compared with the prices generated by the FMMO Class III pricing formula (Figure 2). That is to say, under the proposed amendments, Class 4b prices would continue to be volatile; the proposed amendment does not aid in stabilizing minimum prices. In 13 of the 28 months, the proposed formula resulted in prices greater than FMMO prices, and in 15 of the 28 months, the proposed formula resulted in prices less than FMMO prices.

Analyses

The California milk supply has grown rapidly in recent years, and despite the recent slowdown nationally in milk output, California’s milk production will continue to grow in the years ahead. California dairy producers need viable markets for their milk. For that to happen, the cheese industry must continue to grow as well. Currently, Class 4b represents about 40 percent of the milk produced in California.

California cheese processors compete for market share against cheese processors across and outside of the U.S. for sales, whether the sales occur within or outside of California, and thus, they must be price competitive. The Department has consistently stated that establishing the appropriate Class 4b pricing formula is extremely important because the prices for Classes 4b and 4a must be set at levels that ensure California’s total milk production will be marketed. That is to say, Classes 4b and 4a perform market-clearing functions. The California dairy industry cannot afford to set the prices for these classes of milk so high that some milk is left unpurchased. Unlike federal orders in which manufacturing plants can depool and avoid paying the minimum price, California manufacturing plants are mandated to pay the minimum prices established for Class 4a and Class 4b. With the continued trend toward a manufacturing state, it is beneficial to the California dairy industry to maintain its comparative advantage in selling any manufactured dairy products. To do otherwise would reduce California’s market share in favor of out-of-state processors and possibly leave milk without a viable marketing option in California. Bulk milk that is “distressed” may have to be custom processed, which would return a lower value to the California pool and would effectively lower the price received by all California dairy producers.

The proposed amendment to the Class 4b formula can only increase minimum prices above the level established by the current Class 4b formula. It is, therefore, clear that the amendment would affect negatively the competitive environment facing California’s cheese processors by disrupting the existing price relationship between California cheese processors and cheese processors located in federally regulated markets. Again, the ultimate result of the proposal would be to reduce California’s market share *vis-a-vis* out-of-state processors and possibly leave milk without an outlet in California.

The presence of national dairy processing firms in California adds complexities to the issue of comparable Class 4b/III price levels among neighboring milk markets. Representatives from two

national cheese-producing firms, Kraft Foods and Leprino Foods, indicated that they have the ability and flexibility to supply markets outside California from plants located in other states.

“[Kraft’s] decisions on where to buy and where to make cheese boil down to simple economics. Among factors we must consider are reliability of a quality supply of milk or cheese; transportation and marketing logistics; the state and federal regulatory climate; and, of course, raw product or ingredient price. Recent energy costs, and even more important, electric reliability have become matters of increasing concern across the country, but particularly in California.”

Transferring manufacturing capacity out of the State is not in the best interest of the California dairy industry.

Opponents to the proposal asked, “What is the value that cheesemakers are paying for milk, and does that adequately compensate dairymen for the value of their raw product?” Producers and producer associations may see a need to try to chase down every product produced from milk, establish a make allowance, a yield and a price series that captures the additional revenue generated. However, the reality is that such an approach can become an endless task; the Department would be constantly trying to get the pricing formula “just right”. While administrative convenience is not a factor in establishing the minimum pricing formulas per se, the Department is mindful of maintaining manageable pricing formulas. Continuing to add factors to the pricing formulas as more dairy products are developed may undermine the accuracy of milk prices generated by the pricing formulas; a basic tenet of the Department is the establishment of equitable and reasonable milk prices. Furthermore, from a policy perspective, there is no legitimate reason why noncream whey values need to be included in the formula if the price level generated by the formula is adequate. The points covered in the Background section of this document and in Table 1 and Figure 1 are indicators that the California dairy industry and the California cheese industry are healthy in their current state. It is the Department’s assessment that milk producers in California are not being short-changed by the fact that the Class 4b formula does not include an explicit dry whey factor.

Processors stated that there are transport costs associated with moving cheese processed in California to other the markets. Much of California's bulk cheese production is shipped to the Midwest where it's cut, wrapped, processed and distributed to the nation's primary population centers in the East and Central U.S. For this reason, among others, the Department has recognized that Class 4b prices must be a little lower than the federal Class III price in order to permit California cheesemakers to compete in the national market. Furthermore, data submitted in a post-hearing brief by the Department’s witness indicates that the current formula is not adequately accounting for the price spread between the Chicago Mercantile Exchange and the price California processors receive. In effect, an adjustment to the formula according to the data would be such that minimum Class 4b prices would be lower than they are currently. The price-spread factor was referred to at the hearing, but adjusting it was not part of any proposal. The Department further notes that several factors that impact the Class 4b price may need to be reviewed concurrently, only two of which are a whey factor and the aforementioned price adjuster. Thus, while the Department will not make a recommendation to address the apparent price-spread inequity at this time, it has nevertheless noted the disparity.

Notwithstanding the aforementioned competitive issues raised by proposal, the Department has other concerns regarding the addition of a whey factor in the Class 4b pricing formula.

The petitioners suggest that whey processing has been profitable for Cheddar cheese plants for over ten years. This statement was supported by a rudimentary analysis, consisting of subtracting a fixed manufacturing cost allowance of \$0.14 per pound from published dry whey prices. Clearly, a major determinant for the accuracy of such a statement is the validity of the cost of drying whey used. The petitioners propose using the nonfat dry milk manufacturing cost allowance for this because "...the process of drying whey is very similar to making nonfat dry milk. USDA has assumed the same thing in both the FMMO and support price programs." However, a similar process or procedure does not necessarily imply identical cost. Two processors testified that the estimated cost for drying whey is between 16.6 and 20.2 cents per pound. Among the reasons given for the higher cost is that whey contains less solids than skim milk, so more water must be removed in the drying process. Whey powder production undergoes an additional crystallization process that is unnecessary for nonfat dry milk. There was no evidence submitted into the hearing record to refute the processors' assertion regarding the level of whey drying costs. It appears as though the profitability of dry whey processing spoken to by the petitioners may be overstated, given the higher costs of drying whey testified to by two processors.

Part of the petitioners' support for the addition of a value for whey solids in the Class 4b formula is based on their interpretation of Section 62076 of the Food and Agricultural Code:

"In establishing prices to be paid by handlers to producers for Class 2, Class 3, Class 4a, or Class 4b market milk, the director shall take into consideration any relevant economic factors, including, but not limited to, the following: (a) The relative market value of the various products yielded from such market milk. (b) The market price of other milk which may be used for the same purposes that are set forth in such respective classes. (c) The value of milk used for manufacturing purposes giving consideration to any relevant factors including, but not limited to, product prices, product yields, and manufacturing costs of Class 4a or Class 4b.

The petitioners cited subsection (a) and interpreted this section to mean that because whey has a market value and is produced from milk, its value must be included in the Class 4b pricing formula. The Department takes a broader view of Section 62076 and notes that the Director is instructed to take into consideration *any relevant economic factors*, one of which is the market value of various products produced from milk. The Department considered the relative market value of whey, but considered other relevant economic factors as well — the current level of milk production, the number of cows milked and prices received by producers. None of these three primary economic factors indicates that a price increase is warranted. In combination, these three factors outweigh any consideration given to the relative market value of products yielded from milk.

In its proposed form, the amendment to the Class 4b pricing formula ignores the very large and real plant loss of solids in the whey stream. Department data show that plant whey solids losses

are at least 20 percent in the five plants not processing whey into animal feed with three plants over 33 percent. The lack of recognition of these plant losses indicates that the proposal to include a whey factor in the Class 4b pricing formula is incomplete in its current form.

The petitioners cited the structure of the federal pricing formula for cheese milk as a reason for proposing their amendments. Changes to the federal Class III pricing formula, effective January 2000, resulted in the adoption a product value formula that contains an “other solids” component, which is priced using dry whey commodity prices. Because Class 4b is priced on butterfat and SNF, the proposed amendment would simply add a revenue-generating factor to the SNF portion of the formula. The federal Class III formula “snubs” the whey value to make sure the “other solids” price is never negative; the petitioners propose a snubber to perform a similar function.

Herein lies a conundrum for the Department regarding the addition of a whey factor to the Class 4b pricing formula. The petitioners have effectively extracted portions of the Class III formula and dropped them directly into the Class 4b formula without making any other adjustments to the formula. The Department does not subscribe to the logic of using only the pieces of the federal formula that may be appealing to certain factions of the industry while leaving the remaining factors behind. The Class 4b formula has many other important differences with federal pricing formula, none of which were mentioned by the petitioners. Adding or deleting any of these factors would affect the price level significantly. Some of these differences are:

- the use of the NASS price series or the CME price series,
- the use of only 40 pound blocks or including both blocks and 500 pound barrels,
- separate component prices for protein and other solids (whey) or using SNF pricing to represent both factors,
- the use of the Van Slyke formula or a product value formula for determining component prices,
- the presence of a whey butter factor in the Class 4b formula that is not found its federal counterpart.

Despite the advances made by some of the larger or more progressive plants in producing and marketing specialized whey products, whey processing remains a cost-minimizing waste disposal effort for most plants and not a consistent profit-making venture. For many plants, particularly the smaller or mid-sized plants, whey processing is a means for handling an unwanted byproduct.

Not all plants have the flexibility in their resources to devote to manufacturing marketable whey products, nor do they have the resources to market such products. It is not the Department’s position that all cheese plants in California should have the capability to finance, construct and operate profitable whey processing facilities. Testimony given at the hearing indicate that there are no guaranteed markets or profits with whey products, even for the most advanced cheese processing plants.

Finally, considering the addition of one element to an economic formula, irrespective of the other factors that affect the overall price outcome, makes little sense. The hearing scheduled for May 31, 2001 has an open agenda that invites a complete review of the Class 4b pricing formula. At that time, consideration can be given for all types of changes to all relevant factors that affect the Class 4b pricing level.

Determination — the proposal to add a whey pricing component to the Class 4b pricing formula is not adopted.

FINDINGS OF THE DEPARTMENT OF FOOD AND AGRICULTURE

The Department of Food and Agriculture makes the following findings based upon the testimony and evidence presented at the public hearing held on March 28, 2001 in Sacramento, California and in subsequent post-hearing briefs submitted within the period of time provided by the hearing officer at the above hearing.

The Department has considered all testimony and items of evidence submitted by all parties to these proceedings, whether specifically mentioned herein, in rendering these findings. The Department has considered all provisions set forth in Chapter 2, Part 3, Division 21 of the Food and Agricultural Code, whether specifically mentioned herein, in rendering these findings. These include, without exception, all provisions and declarations regarding public interest considerations.

It is hereby found and concluded that the current Stabilization and Marketing Plans for Market Milk now in effect continue to be in conformity with the standards prescribed in and do tend to effectuate the purposes of said Chapter 2.

Tad Bell, Undersecretary
California Department of Food and Agriculture

Signed and entered in
the Office of the Secretary
of Food and Agriculture at
Sacramento, California,
On May 21, 2001